Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:JAX:[redacted]:TL-N-2042-00
[redacted]

date: December 28, 2000

to: [redacted]

from: Associate Area Counsel, (LMSB [redacted])

subject: [redacted]

EIN: [redacted]

This is in reply to your memorandum requesting our opinion on the issues stated below:

ISSUES

1. Whether three corporations each formed under the laws of the State of [redacted] for the purpose of establishing, maintaining and operating a nonprofit hospital and medical service corporation, were entitled to file a consolidated return for each of the years [redacted], [redacted], and [redacted], while operating under an affiliation agreement prior to their merger.

2. If so, whether the consolidated group was entitled to claim the current year losses of one of the three corporations in each of the three years involved.

CONCLUSIONS

1. Yes, based on Rev. Rul. 69-591, 1969-2 C.B. 172, the affiliated group, notwithstanding the absence of actual stock in the corporations, would appear to be entitled to file a consolidated return under I.R.C. § 833 and Treas. Reg. § 1.1504-1.

2. Yes, if the losses for the loss corporation constitute current year losses for the years involved and not net operating losses carried forward from any prior years so as to violate the SRLY limitations of Treas. Reg. § 1.1502-21A(c).

FACTS

In [redacted], [redacted] and [redacted], agreed to an affiliation arrangement effective [redacted]. The agreement included the formation of a new holding corporation ([redacted]) to become the sole member of each with all the rights granted under the charter of each corporation as provided under [redacted]. ([redacted]). [redacted] changed its name to [redacted], and [redacted] changed its name to [redacted] ([redacted]). There was no immediate merger. [redacted], ([redacted]) remained in existence as a separate entity from [redacted] as did [redacted] ([redacted]).

As of [redacted], [redacted] and [redacted], merged with and into [redacted] with the latter corporation being the surviving corporation. A plan of merger was adopted and approved by the Board of Directors of each of the corporations on [redacted] pursuant to [redacted]. Also on [redacted] pursuant to [redacted], [redacted] amended its charter to change its name to [redacted] with its principal office at the address stated above. Some of the pertinent provisions of the amended and restated charter of the surviving corporation are quoted below (similar provisions were in the charter of the prior corporations):

[redacted] The corporation is not for profit.
The corporation is a mutual benefit corporation.
[redacted] The corporation is formed for the purpose of establishing, maintaining and operating a non-profit hospital and medical service corporation in accordance with the terms and provisions of [redacted],
[redacted] The corporation shall not have any members.
The board of directors shall be composed of:
[redacted] administrators of hospitals which have contracted with the corporation to render hospital service to the subscribers;
[redacted] physicians, exclusive of group (1); and
the general public, exclusive of group (1) and (2).
The directors shall be elected so that at all times more than 50% of the members of the board will be members of group (3) and the remaining positions shall be divided equally between members of groups (1) and (2).
[redacted] In the event of the dissolution of the corporation or the winding up of its affairs, or other liquidation of its assets,

the corporation's property remaining after satisfaction of all outstanding obligations of the corporation shall be conveyed or distributed to such organization or organizations created and operated for non-profit purposes as shall be designated by the board of directors.[redacted]

In our memorandum of November 15, 1999, in response to your inquiry, we opined that the taxpayer as survivor by merger appeared to be the proper entity to execute a Form 872 for [redacted] and [redacted] for the two groups but suggested that to be sure that you solicit from the remaining members of each group a notice of designation that [redacted], is authorized to act as the new agent for the two groups pursuant to Treas. Reg. § 1.1502-77(d).

With your current inquiry regarding the right of the group to file consolidated returns, you forwarded the affiliation and operating agreement and numerous other documents reflecting the amended and restated charter and bylaws of each of the two groups as well as the charter and bylaws of the holding company. We note that one of the conditions precedent of the affiliation was that the accounting firm of [redacted], would receive an opinion to the effect that the affiliation would be treated as a tax free reorganization under the Internal Revenue Code and that the affiliation shall not be deemed a "material change" as that term is used in I.R.C. § 833(c), which section [redacted].

The key elements of the merger according to a statement issued by the companies is to allow them to serve the people of [redacted] better as a statewide organization than as two separate companies. In such statement the parties further point out that the merger is not a takeover but a coming together of two organizations with similar backgrounds and goals. The key advantages of the statewide organization are stated to include stronger financial capabilities, the ability to attract top level staff, the improvement of managed care capacity, more effective and efficient operations and better systems capabilities, all of which translates into improved service to the companies' customers.

During the three year transition period covered by the affiliation agreement, the entities were to remain in existence with a minimum of [redacted] employees based in [redacted]. The [redacted] CEO was named the CEO of the merged entity. The [redacted] CEO was second in command, reporting to the [redacted] CEO, and was a member of the statewide board. Under the affiliation agreement and the merger there was to be a board of

[redacted] members, with [redacted]% from the [redacted] area. All employment contracts were to be honored during the affiliation. Joint committees of the management staff were to develop details of the merger with conflict resolutions provided by the Merger Committee of the Boards.

The two companies involved are mutual benefit not-for-profit corporations with exclusive [redacted] territories. [redacted] covered the territory surrounding [redacted] or the "[redacted] Area" while [redacted] covered the territory representing the balance of the State of [redacted]. [redacted] (formerly [redacted]) was formed as a holding company in order to effectuate the affiliation and operating agreement under which [redacted] and [redacted] were to operate in anticipation of a merger of the companies. In accordance with the amended charters of [redacted] and [redacted] each corporation was to have "one member" which would be [redacted]. Under the amended charter and bylaws of the corporations, and the laws of the State of [redacted] the membership interest of the parent had similar characteristics and responsibilities of stock ownership in a for-profit company. For example, as the sole member of [redacted] and [redacted],, [redacted] had the right to elect the board of directors of each corporation which board had the authority to exercise all powers and affairs of the corporation. [redacted] In addition, the amended charter of each of the subsidiary corporations provided that the bylaws of the corporation could be altered or amended only by vote of the sole member of the corporation. Under the amended charter, each corporation could not sell or encumber its assets without the consent of the sole member and upon dissolution or the winding up of the corporation's affairs, the corporation's property remaining after satisfaction of its obligations were to be conveyed to the sole member or a nonprofit organization designated by the sole member.

For each of the years [redacted], [redacted], and [redacted], [redacted] and [redacted] filed a consolidated return in which the Group claimed the current losses of [redacted] in the following respective amounts: ($[redacted]), ($[redacted]) and ($[redacted]). These returns are under audit.

ANALYSIS

Section 833 of the Internal Revenue Code provides that for years after [redacted], a [redacted] organization shall be taxable in the same manner as if it were a stock insurance company. Therefore, the statutes and regulations under the Internal Revenue Code applicable to the filing of consolidated income tax returns for corporations (including insurance companies) are applicable to the groups involved here for the

years [redacted], [redacted], and [redacted]. Section 1501 of the Internal Revenue Code provides that an affiliated group of corporations shall have the privilege of making a consolidated income tax return for the taxable year in lieu of separate returns. Section 1504(a) provides that the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, if stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock of each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations.[1]

In Rev. Rul. 69-591, 1969-2 C.B. 172, the Service ruled that an affiliated group may come into existence, notwithstanding the absence of actual stock holding in a subsidiary. Such Rev. Rul. provides that the term "stock" as used in the consolidated returns provisions is not restricted to cases where formal certificates have been issued, but the term is considered to have the same meaning as "shares of stock", or the right which owners have in the management, profits and ultimate assets of a corporation. [redacted], as noted above, under the affiliation agreement and the laws of the State of [redacted] would appear to have the rights of stock ownership described above in each of the two groups notwithstanding that no actual shares of stock had been issued with respect to the corporations. Thus, the group would appear to qualify as an "affiliated group" within the meaning of I.R.C. § 1504(a).

Accordingly, under Rev. Rul. 69-591 and Sections 1504(a)(1) and (2) of the Code, the affiliated group in our opinion is entitled to file a consolidated federal income tax return for each of the years under which the corporations operated under the affiliation agreement, i.e., [redacted], [redacted], and [redacted].

As a result, the losses claimed on such returns from the operations of [redacted] would be allowable if in fact the losses represent current year losses of [redacted]. However, we cannot help but note that the privilege of filing a consolidated return carries with it the responsibility of computing the income and deductions allowable on such returns under the complicated rules of Section 1502 and the Regulations thereunder. We note in particular the separate return limitation year (SRLY) rules designed to discourage the affiliated corporations from acquiring

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[1]Under I.R.C. § 1504(b) an "includible corporation" means any insurance corporation except a life insurance company (with the exception noted at I.R.C. § 1504(c)).

a loss corporation merely to obtain an NOL carryover. For example, we note that even though as a general rule net operating losses reported on separate returns can be carried over and used on a consolidated return, an exception to this rule is found in Treas. Reg. § 1.1502-21A(c). This section provides that the NOL of a member of an affiliated group arising in a separate return limitation year(SRLY) maybe included in the consolidated NOL deduction of the group provided that such loss does not exceed the amount of the consolidated taxable income contributed by the loss sustaining member for the taxable year at issue.

Losses incurred by a corporation before it becomes a member of an affiliated group filing a consolidated return can only be carried forward and used on a consolidated return to the extent that the corporation that incurred the losses has current income reflected on the consolidated return. See Wolter Construction Co. v. Commissioner, 634 F. 2d 1029 (6th Cir. 1980) 80-2 USTC ¶9799. In view of the apparent financial troubles of [redacted] leading to the affiliation agreement, we suggest that in recognizing the groups right to file a consolidated return, that you make certain the SRLY limitations have been followed. We, of course, will be happy to assist you in resolving any question that may arise regarding the proper computation of the consolidated income.

This writing contains privileged information. Any unauthorized disclosure of this writing will have an adverse effect on privileges, including the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

One final word of caution. We note that our conclusion here on the right to file the consolidated return is essentially the same as that reached in PLR 8913029 (Dec. 29, 1988) a copy of which was supplied to the examining officer and relied upon by the taxpayer's representative. However, since such ruling may not be cited as a precedent under I.R.C. § 6110(j)(3) and in the absence of any other specific rulings on the question, we are forwarding our opinion to our National Office for post review.

We hope to advise you of the National Office's reply within 20 days. In the meantime, if you have any questions, do not hesitate to telephone the undersigned any time at [redacted].

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By: [redacted]
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cc: Peter J. Graziano, AAC (PF/TG) Area 1
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